FINANCIAL MARKETS LAW COMMITTEE

COVID-19: Legal issues for financial markets

1. Introduction

1.1. The novel coronavirus (COVID-19) is having an immense, if rapidly evolving, impact on individuals, communities, and organisations. In addition to effects on the supply and demand, COVID-19 has jolted the financial markets. Since 21 February 2020, bond yields, oil, and equity prices have sharply fallen, and trillions of dollars, across almost all asset classes, have sought safety. In the United States, 10-year bond yields have tumbled below 0.5 percent and equity prices on major stock indices around the world have fallen.

1.2. Given the response by governments around the world to COVID-19, which has included steps such as closing down places of business and restricting the movement of people, several legal issues are likely to arise in the context of the financial markets.[1] The Committee has met remotely and decided it might be helpful to list, as set out below, some of the legal complexities arising in this context.[2]

2. Contractual issues

a. Force majeure: Many contracts contain *force majeure* provisions that will release a party from liability for breaching its obligations (or failing to supply) to the extent that they are prevented from doing so for either specific reasons or something outside of their reasonable control. Sometimes, that release will only be granted if that party has implemented a responsible business continuity and disaster recovery plan, has provided notice and has also taken steps to mitigate the loss to the other party. Some customers may benefit from express rights not to pay for products or services not received and to terminate contracts if the *force majeure* event (i.e., COVID-19) has prevented performance for a defined period of time.

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[1] The contents of this briefing note are for information purposes only. Nothing in this note constitutes legal advice. The FMLC is a research organisation which considers abstract issue. It is not in a position to offer legal advice on these (or any) questions as they may arise on the particular facts of a matter or in a specific context.

[2] In 2003, the FMLC published, in the light of the events of 11 September 2001, a report setting out an analysis of how the law and market practice would respond to an event of major operational disruption. FMLC, *Report: Emergency Powers Legislation* (1 November 2003), available at: http://fmlc.org/emergency-powers-legislation-report/

b. Frustration, wrongful termination and wilful default: There may be some businesses for which COVID-19 is not preventing performance (so they cannot rely on *force majeure*), but in which it makes continued performance financially undesirable. In this case, they may try to argue that there has been a material adverse change—if the contract allows for that to trigger termination—or that the contract is frustrated and is therefore terminated immediately. The threshold for frustration, in the U.K., is very high (the supplier's obligations must have become impossible, illegal or radically different from what was contemplated when the contract was made); some contracts will explicitly exclude rights of termination that are not expressly stated in them; arguing wrongly that a contract is frustrated brings with it the spectre of liability for wrongful termination; and this liability could be even higher if there is also uncapped liability for wilful default or wilful abandonment.

c. Material adverse change: Whether or not a material adverse change ("**MAC**") clause gives a party to the contract the right to terminate in the event of the company's operations being affected by COVID-19 will depend on the wording of the relevant clause and the relevant circumstances. As a general rule, it is harder to trigger the clause where the circumstances which give rise to the MAC are known at the time the contract is entered into.

d. Clauses with respect to events of default: Some financing contracts—particularly loan and derivatives contracts—include clauses which explicitly enumerate the situations that will constitute an "Event of Default" ("**EoD**") under the agreement. In general, the clause includes events such as insolvency/bankruptcy, repudiation of the agreement and failing to perform obligations, among other things. In the context of COVID-19, complexities arise in respect of (1) extended "Bankruptcy" EoD clauses which capture circumstances in which discussions are commenced with creditors with a view to rescheduling indebtedness; (2) "Repudiation" EoD clauses where parties cease, or threaten to cease, to adhere to a substantial/material part of the agreement; and (3) "Failure to Pay/Deliver" EoD clauses in circumstances where the client may be limited in its ability to fulfil its obligations by virtue of governmental action.

e. Wet signatures and notarisation: The restrictions on the movement of people has brought into focus complexities relating to the need for "wet" signatures in contracts in cases where electronic execution is not possible. For example, global notes need to be authenticated by two wet signatures before they become "live securities". This is unlikely to be possible in a "social distancing" economy. Similar concerns arise when documents need to be signed in the presence of a notary.[3]

f. Applicable law: In U.K. courts, in civil and commercial matters, the rules on applicable law in contracts are set out by Regulation (EC) No 593/2008 on the law applicable to contractual obligations ("**Rome I**"). Under Rome I, effect is generally given to the parties' express choice of law. There are, however, limited exceptions which may, depending on the circumstances, apply. Article 9 of Rome I provides overriding mandatory provisions—i.e., provisions which may be regarded as crucial by a country for safeguarding its public interests, such as its political, social or economic organisation, to such an extent that they are applicable to any situation falling within their scope, irrespective of the law otherwise applicable to the contract. Article 9(3) of Rome I permits effect to be given to the overriding mandatory provisions of the law of the country where the obligations arising out of the contract have to be, or have been, performed, in the event those provisions render the performance of the contract unlawful. It is possible that the restriction of movement or the imposition of unscheduled holidays could render a contract unlawful in the country in which it is to be performed.

g. Insurance contracts: There is likely to be an increase in business interruption insurance claims resulting from lost sales and interrupted supply arrangements. There are two key uncertainties in this context: (1) there is a possibility of disagreement about when the insurance pay-out has been triggered; and (2) disagreement between insurers and reinsurers about the aggregation of losses in order to maximise recovery. While insurance coverage is relatively straightforward for interruptions tied to events like fires, floods, and other perils—classic contractual *force majeure* situations—a public health crisis falls under the much less clear category of a "contingent business interruption"—an event involving the insured's premises that interferes with production. As the 2003 SARS epidemic in Hong Kong demonstrated, a key issue in disease-related contingent interruptions is official government recognition of the situation such as classifying it as a "legally

[3] The Governor of the State of New York issued the attached executive order temporarily suspending the provisions under the NY Public Officer's Law that require a New York notary to be in the physical presence of the personal swearing an oath or giving an acknowledgement. See: Executive Order No. 202.6: Continuing Temporary Suspension and Modification of Laws Relating to the Disaster Emergency (18 March 2020), available at: https://www.governor.ny.gov/news/no-2026-continuing-temporary-suspension-and-modification-laws-relating-disaster-emergency.

notifiable disease." Often, critical policy language limits coverage to cases in which those magic words are present and can spell the difference between coverage and exclusion. As to the latter, the purpose of aggregation clauses in reinsurance contracts is to enable two or more separately covered losses to be treated as a single loss for deductible or other purposes when linked by a unifying factor. In cases where insurance companies authorise payment, reinsurance may not be available easily owing to variation in aggregation language.

h. Negative interest rates: In the event of negative interest rates, parties to existing contracts may argue that their contracts no longer reflect their original intention. The FMLC's sister organisation, the Financial Law Board ("**FLB**"), attached to the Bank of Japan, has conducted in-depth analysis on the legal uncertainties arising in the context of negative interest rates.[4]

3. Institutional issues

a. Collateral demands under OTC Derivatives: For a broad range of commercial reasons, corporates could be trading over-the-counter derivatives varying from foreign exchange, interest rates, commodities and equities through to freight forwards. The first casualties of any large market movements are often non-bank counterparties who are holding the wrong side of a trade (or a series of trades) in a particular market and are suddenly faced with collateral demands they cannot meet. Over-the-counter derivatives often require that the party that is out of the money must provide collateral (usually cash or other liquid assets) to cover potential losses. A sudden and unexpected market movement, whether it be in equities, interest rates, foreign exchange or commodities prices, can impose a significant collateral liability on a counterparty on a daily basis based on the market value of their trading positions. Further collateral liabilities may accumulate for days or weeks if the relevant market continues to move against the counterparty. This can lead to cash flow problems for the affected counterparty and eventually the counterparty can reach a point where it can no longer meet collateral calls. A failure to meet a collateral demand can lead to the close-out (i.e. termination) of all outstanding derivatives transactions. Typically, following a formal demand, the

4 FLB, *Outline of the Approaches to Issues in Interpreting Contracts that Arise in Connection with the Introduction of a Negative Interest Rate* (26 February 2016), available at: http://www.flb.gr.jp/epage/edoc/publication44-e.pdf

counterparty has only a few days to post the collateral. If this is not done, the non-defaulting party will have the right to terminate all outstanding transactions, value the terminated transactions and require the defaulting party to pay the net amount calculated to be due. Whether a party will choose to terminate or not, and whether it will seek to rely on any other protections such as so-called "flawed assets," will depend upon a number of factors, including whether it is in or out of the money (i.e. would be receiving or making a payment on termination).

b. Insolvency law and directors' duties: Whether arising directly in the context of a default or from the consequences of the pandemic more generally, there is a real issue for directors of companies about the potential "wrongful trading" consequences of continuing to trade in the light of concerns about their ability to meet their payment obligations to their creditors. Germany has introduced legislation to give some protection to directors in this context.[5] It remains to be seen whether other governments or regulators will amend existing insolvency law to grant directors a temporary "safe harbour" from wrongful trading liability.[6] If Governments attempt to do so, legal uncertainty may arise unless the provision is carefully drafted to give relief from all relevant statutory, Common Law and regulatory duties.

c. Negative interest rates: In the event of negative interest rates, commercial banks and other financial institutions are charged for holding excess reserves (i.e., beyond the regulatory minimum) with a Central Bank. Banks will seek to avoid such penalties, and it is expected will boost the economy by lending this money to consumers and businesses instead. Thus, low rates can strengthen economic conditions by boosting aggregate demand, but they also raise concerns because—by reducing the income from interest-bearing assets—they may hurt the profitability of banks and may, in a volatile market, undermine institutional stability.

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[5] On 25 March 2020, the German parliament passed a comprehensive package of legislative measures titled "Law to Mitigate the Consequences of the COVID-19 Pandemic in Civil, Insolvency and Criminal Procedure Law". German insolvency law contains rigid obligations for directors to file a company for insolvency without undue delay, but no later than three weeks after the company has become insolvent (i.e. illiquid or balance-sheet insolvent). These obligations to file for insolvency will be suspended until 30 September 2020. This relief, however, does not apply if the insolvency is not a consequence of the COVID-19-pandemic or if there are no prospects of eliminating an existing illiquidity.

[6] In the U.K., Business Secretary, Alok Sharma, has said that the wrongful trading law would be suspended to protect directors during the pandemic. The anticipated changes include a temporary moratorium for businesses undergoing a restructuring process, during which time they cannot be put into administration by creditors and will continue to be able to access all raw materials. Mr Sharma said the legislation will be introduced in Parliament at the "earliest opportunity". See Hughes, L., "UK to change insolvency rules to protect businesses", *Financial Times*, (28 March 2020), available at: https://www.ft.com/content/ad5d47d3-1572-4d67-b0b6-e64c5858c848.

4. Market issues

a. Unscheduled holidays, payments and deliveries and notices: Announcements in relevant financial centres for unscheduled holidays and market closures might affect settlements and valuations, and even trigger a disruption event, in which case an applicable fallback might be needed. In some circumstances, the electronic delivery of notices may not be sufficient, requiring instead in-person or postal delivery, which may be prevented by official "social distancing" rules. The consequences may be different for different asset classes, including issuers or underwriters working on international offerings of securities, market participants entering into derivatives and agents or lenders on loan financings.

Such events may affect the performance of obligations under documentation such as the International Swaps and Derivatives Association, Inc. ("**ISDA**") or other market standard documentation. In order to assess the rights of the parties, typically two levels of inquiries are to be made: first, whether such an event (or any consequent non-performance) would constitute an event of default or a termination event under the relevant master agreement; and secondly, whether any particular disruption event which is already provided for in the transaction has been triggered, and if so, whether those provisions will take precedence over the termination provisions in the applicable master agreement.

b. Payment moratoria/relief measures: National governments and regulators have introduced or issued statements regarding payment moratoria and associated relief measures in response to the disruption.[7] In some cases, these are backed by law—such as the Spanish Royal decree-law 8/2020 on urgent and extraordinary

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[7] For example, European Banking Authority, *Statement on the application of the prudential framework regarding Default, Forbearance and IFRS9 in light of COVID-19 measures* (25 March 2020), available at: https://eba.europa.eu/sites/default/documents/files/document_library/News%20and%20Press/Press%20Room/Press%20Releases/2020/EBA%20provides%20clarity%20to%20banks%20and%20consumers%20on%20the%20application%20of%20the%20prudential%20framework%20in%20light%20of%20COVID-19%20measures/Statement%20on%20the%20application%20of%20the%20prudential%20framework%20regarding%20Default%2C%20Forbearance%20and%20IFRS9%20in%20light%20of%20COVID-19%20measures.pdf.

Prudential Regulation Authority, *"Dear CEO" Letter on COVID-19: IFRS 9, capital requirements and loan covenants*, (26 March 2020), available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2020/covid-19-ifrs-9-capital-requirements-and-loan-covenants.pdf.

measures to fight social and economic impact of COVID-19—whilst others involve governments and regulators urging lenders to grant forbearance and show support to borrowers by granting "payment holidays". The terms of the payment "holiday" or "moratorium" may be different in different jurisdictions and across different asset classes. For example, some may involve capitalisation of interest payments (so-called "Payment In Kind" ("**PIK**") relief) or a deferral of payment, and there may be differences as to whether interest is charged on the "deferred" payment etc. The imposition of a moratorium or grant of relief in respect of a payment obligation may affect the analysis on whether a "credit event" (most commonly, a bankruptcy, failure to pay or restructuring) has occurred under a credit derivative transaction either under an ISDA-based credit default swap transaction or under the more bespoke definitions of "bankruptcy", "failure to pay" and "restructuring" credit event definitions seen in significant risk transfer transactions (also known as synthetic securitisations or regulatory capital trades).

Such measures are also likely to have an effect on securitisation transactions, both public and private. Whilst public transactions may have cash reserves and liquidity facilities built into the transaction structure to mitigate the effects of a reduction of cashflow coming into the structure, the private asset-backed securitisation transactions (which are often structured as "borrowing base" facilities) are more vulnerable. These often have financial covenants based on pre-agreed triggers which apply to "delinquent" and "defaulted" receivables (generally 30-60 days and 90 days past due, respectively) and which, if breached, result in the facility going into early or rapid amortisation or default. Similarly, these measures may result in the value of the "borrowing base" being deemed to be reduced which would require a repayment of principal to be made to bring the borrowing vase into compliance, and there may be insufficient cash in the structure to make that repayment which, in turn, may result in the transaction falling into early amortisation or default. This would bring to an end the originator's ability to keep funding its new business, and the receivables portfolio would effectively be in wind-down. It may also result in a Servicer Termination Event allowing the lender to replace the Servicer (normally the original Servicer is the originator or a member of its group and would be entitled to a servicing fee).

c. <u>Negative interest rates:</u> In the context of negative interest rates, benchmark interest rates (LIBOR, TIBOR, etc.) in transactions such as floating rate-linked loans and derivative transactions that refer to floating rates could ultimately become negative.

This would have significant impact on the markets as conventional payment flows reverse direction, likely leading to contrarian and unpredictable market behaviours. It may also have an impact on the performance of contracts owing to the lack of practical adaptations. When negative rates first appeared two decades ago in Japanese yen money markets, local bank computing systems went haywire.[8] In some jurisdictions, investors and lenders may argue that, even without specific provision to that effect, their contract does not contemplate the reversal of payment flows that logically accompanies negative interest rates.

d. <u>Negative oil prices:</u> The coronavirus outbreak coupled with the Saudi-Russian oil price war means that oil prices may drop below zero as oil supply outstrips demand and suppliers are forced to pay to store any oil produced.[9] Parties to existing contracts may argue that their contracts no longer reflect their original intention.

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8 See: Gillian Tett, "Negative interest rates take investors into surreal territory", *Financial Times,* (19 September 2019), available at: https://www.ft.com/content/09360f2e-98b4-11e9-9573-ee5cbb98ed36.

9 Oil prices have fallen by more than half over March. In the US, crude oil prices fell below $20 a barrel shortly after trading reopened on 29 March 2020. See: Sheppard, D. and Brower, D, "US crude oil price falls below $20", *Financial Times*, (30 March 2020), available at: https://www.ft.com/content/bc938195-82d3-43eb-b031-740028451382.